THE SMOKE SHOP, INC. 1908 Highway 31 S Birmingham, AL 35244-1107,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 04-620
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed The Smoke Shop, Inc. ("Taxpayer") for State sales tax for November 2000 through December 2003. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on February 10, 2005 in Birmingham, Alabama. Sam McCord represented the Taxpayer. Assistant Counsel David Avery represented the Department.

ISSUES

This case involves two issues:

(1) Did the Department properly compute the Taxpayer's sales tax liability for the subject period using a purchase mark-up audit; and,

(2) Did the Department properly assess the Taxpayer for the 50 percent fraud penalty levied at Code of Ala. 1975, §40-2A-11(d).

FACTS

The Taxpayer operated a self-described "mom and pop" tobacco outlet/convenience store in Birmingham, Alabama during the period in issue. The business primarily sold gasoline, cigarettes, beer, and various grocery items.

The business was owned by David Ingram, but was operated by Ingram's wife, Debbie Graham. Graham started working at the store for her father-in-law in the late

1980's.

The Department audited the Taxpayer for the period in issue and requested the Taxpayer's sales records, purchase invoices, bank records, and other relevant records. The Taxpayer provided some cash register z-tapes and purchase invoices. The Department examiners determined that the z-tapes were incomplete, and thus could not be used in conducting the audit. Consequently, the examiners instead determined the Taxpayer's liability using a purchase mark-up audit. Simply stated, a retailer's total liability is determined under a purchase mark-up audit by applying a percentage mark-up to the retailer's wholesale purchases. A credit for tax previously paid is then allowed to arrive at any additional tax due.

The Department examiners computed the Taxpayer's total purchases using the Taxpayer's purchase invoices, account receivable information from the Taxpayer's primary tobacco vendor, and canceled checks. They then applied the standard 24.8 percent mark-up commonly used by the IRS concerning convenience stores. The Department also added a 50 percent fraud penalty because the Taxpayer's reported monthly sales averaged less than 20 percent of its monthly wholesale purchases.

Debbie Graham conceded at the February 10 hearing that she sometimes failed to file monthly sales tax returns or filed the returns late. She also conceded that the business may owe some additional sales tax, but not the full amount assessed by the Department. In support of that claim, the Taxpayer submitted audits conducted on behalf of the City of Pelham and Shelby County for June 2000 through May 2003. The combined 4 percent local sales tax due to those entities totaled approximately $37,000, whereas the additional 4 percent State tax assessed by the Department is $56,242. The City of Pelham and

Shelby County also assessed the Taxpayer for only a 10 percent penalty instead of the 50 percent fraud penalty.

Graham testified that her father-in-law never used an accountant when he ran the business. She likewise does not have an accountant, and started doing the taxes herself when she took over the business. She explained that she had always computed her monthly State sales tax liability as follows: She totaled the cash register z-tapes at the end of each month and then multiplied the total monthly sales by the combined 8 percent State, county, and city tax due. She entered that 8 percent amount on the "Gross Tax" line on her State sales tax return. She then multiplied that amount by the 4 percent State tax due. For example, if the Taxpayer's total monthly sales were $40,000, Graham multiplied that amount by 8 percent to arrive at $3,200. She then multiplied the $3,200 by the 4 percent State rate to arrive at tax due of $128.

The Administrative Law Division obtained the Taxpayer's sales tax returns for the period in issue after the February 10 hearing. Those returns confirm that in most months the Taxpayer's returns were completed as indicated above. Graham testified that she had always done the taxes that way, and that nobody had ever told her she was doing it wrong.

Issue (1) – The purchase mark-up audit.

The Department's use of a purchase mark-up audit is an accepted method of computing a taxpayer's liability in the absence of adequate records. See, *Alsedeh, d/b/a Attalla Tobacco Outlet v. State of Alabama*, S. 03-549 (Admin. Law Div. 11/3/04), and cases cited therein at 6.

The Department examiners in this case properly conducted the purchase mark-up audit using the Taxpayer's records and information from the Taxpayer's primary tobacco

vendor. The 24.8 percent mark-up based on the IRS chart is also reasonable under the circumstances. The Taxpayer failed to offer any evidence contradicting the audit. It is not known how the Shelby County and City of Pelham audits were conducted. Consequently, the fact that the combined 4 percent County and City tax found to be due was less than the 4 percent State tax due per the Department's audit is of no consequence. The Department examiners conducted a good audit. The Taxpayer's sales tax liability as computed pursuant to the mark-up audit is affirmed.

Issue (2) – The fraud penalty.

Code of Ala. 1975, 40-2A-11(d) levies a 50 percent penalty for any underpayment due to fraud. For purposes of the penalty, fraud is given the same meaning as ascribed in the federal fraud provision, 26 U.S.C. §6663. Consequently, federal authority should be followed in determining if the fraud penalty applies. *Best v. State, Dept. of Revenue*, 423 So.2d 859 (Ala. Civ. App. 1982).

The Department is required to prove fraud by clear and convincing evidence. *Bradford v. C.I.R.*, 796 F.2d 303 (1986). "The burden is upon the commissioner to prove affirmatively by clear and convincing evidence actual and intentional wrongdoing on the part of the (taxpayer) with a specific intent to evade the tax." *Lee v. U.S.*, 466 F.2d 11, 14 (1972), citing *Eagle v. Commissioner of Internal Revenue*, 242 F.2d 635, 637 (5th Cir. 1957). The existence of fraud must be determined on a case-by-case basis, and from a review of the entire record. *Parks v. Commissioner*, 94 T.C. 654, 660 (1990). The mere underreporting of tax is by itself insufficient to establish fraud, unless coupled with other circumstances showing a clear intent to evade tax. *Barragan v. C.I.R.*, 69 F.3d 543 (9th Cir. 1995).

The issue in this case is not whether the Taxpayer substantially underreported its tax due in each month of the audit period. Clearly it did because of Graham's bizarre method of computing the tax due in each month. Rather, the issue is whether Graham knowingly underreported the tax due with the intent to evade. In my opinion, she did not.

Sales tax fraud is usually evidenced by an intentional and substantial underreporting of taxable sales on a return. See again, *Alsedeh, d/b/a Attalla Tobacco Outlet, supra*, and cases cited therein at 6. In this case, however, Graham never put her taxable gross receipts ("Measure of Tax" on line 4 on the back of the return) on the returns. Rather, the first figure shown on the returns (with some few exceptions) is the 8 percent "Gross Tax" amount on line 5. As discussed, she then multiplied that amount by the 4 percent State rate to determine what she thought was the State tax due.

Graham was not hiding how she computed her taxes because anyone looking at the returns would have seen that she was not reporting her gross receipts on the returns. Also, the "Gross Tax" amounts reported on the returns averaged only $3,000 to $3,500 a month, which clearly should not have been mistaken for the monthly gross sales at a high volume tobacco outlet/convenience store.

The Administrative Law Division has consistently affirmed the Department's assessment of sales tax fraud in all but one case.[1] But the facts in this case when viewed together do not support a finding that Graham intentionally attempted to evade her sales

[1] The one exception is *American Legion Post 322 v. State of Alabama*, S. 00-701 (Admin. Law Div. 7/20/01). Cases in which the fraud penalty was affirmed include *Alsedeh v. State of Alabama*, S. 03-549 (Admin. Law Div. 11/3/04); *Arnold v. State of Alabama*, S. 03-1098 (Admin. Law Div. 7/27/04); *Smith v. State of Alabama*, S. 03-538 (Admin. Law Div. 3/9/04); *Chelsea A v. State of Alabama*, S. 01-172 (Admin. Law Div. 5/29/02), and others.

(continued)

tax liability during the subject period. Her method of filing was overt and she never attempted to hide anything. Anyone intentionally underreporting sales tax also would not periodically fail to file a return or file a return late, and thereby bring the delinquent account to the Department's attention.[2]

The fraud penalty should be deleted, and instead, the failure to pay and negligence penalties should be applied, as appropriate. A Final Order will be entered after the Department notifies the Administrative Law Division of the adjusted amount due.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered April 12, 2005.

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BILL THOMPSON
Chief Administrative Law Judge

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[2] The Taxpayer is on notice that its sales tax liability must be properly computed in the future. If Graham has any questions concerning how the Taxpayer's sales tax should be reported, she should contact the Department. Any failure to properly compute the Taxpayer's sales tax in the future will be viewed as intentional unless proven otherwise.